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Supreme Court of the United States

October Term, 1952

No. 521

CENTRAL BANK, a Corporation, *Petitioner*

vs.

THE UNITED STATES, *Respondent*

On Writ of Certiorari to the United States Court of Claims

BRIEF FOR PETITIONER

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OPINION BELOW

The opinion of the Court of Claims (R. 75-79) is reported in 105 Fed. Supp. 992.

JURISDICTION

This is a proceeding to review a judgment of the Court of Claims, entered July 15, 1952 (R 79).

Jurisdiction is conferred on this Court by Section 1255, Title 28, United States Code (62 Stat. 928).

Certiorari was granted by this Court on March 9th, 1953.

STATEMENT OF THE CASE

The essential facts are not in dispute; they are briefly as follows:

The petitioner is a California Banking Corporation, engaged in the banking business at all of the times involved in this suit (R. 68).

On December 30, 1944, Graham Ship Repair Company, a partnership, entered into a contract, NOBs—10230, with the Navy Department of the United States for ship repair work (R. 10-56; 69); Article 15 (b & c) of this contract authorized Graham Ship Repair Co. to assign monies due or to become due to it, under said contract, to any bank, as security (R. 34-35).

Graham Ship Repair Co. arranged with petitioner that petitioner should advance funds to it, to enable Graham Ship Repair Co. to carry out said ship repair contract; on January 31, 1945, Graham Ship Repair Co. assigned all monies due or to become due to it, under said contract, to petitioner, as security for funds so advanced and to be advanced by petitioner (R. 56-58; 69). This assignment was made under and pursuant to the provisions of the Assignment of Claims Act of 1940, 54 Stat. 1029 (R. 58; 69).

After the execution of said assignment, petitioner did loan substantial sums of money to Graham Ship Repair Co. to pay for labor and material costs of ship repairs performed by Graham Ship Repair Co. under said Navy contract NOBs-10230 (R. 70).

Graham Ship Repair Co. withheld $453,469.55 withholding tax and $11,462.91 Federal Unemployment Tax, from the salaries and wages of its employees engaged in the ship repair work under said Navy contract NOBs-10230; these amounts were withheld by Graham Ship Repair Co. under the requirements of Sections 1401 and 1622 of the Internal Revenue Code. Graham Ship Repair Co. failed to pay over to the Collector of Internal Revenue said sums withheld, and converted the same to its own use (R. 70). Because of this, no further ship

repair job orders were given to Graham Ship Repair Co., after March 31, 1946; the partners of Graham Ship Repair Co. were indicted and convicted of wilful attempt to evade payment of said withheld tax monies (R. 70).

At termination of said contract, there was due, for work performed under it, the sum of $110,966.08; at that time, also, Graham Ship Repair Co. was indebted to petitioner for amounts in excess of $110,966.08, for monies advanced by petitioner to Graham Ship Repair Co. to pay for labor and material costs of said ship repair contract (R. 70).

At termination of said contract, Graham Ship Repair Co. was liable to the United States for the withheld tax monies it had converted, plus penalties and interest as to same, in the total sum of $616,750.95 (R. 70).

Petitioner claimed the amount due under said Navy contract, $110,966.08, under the assignment to it by Graham Ship Repair Co. The Commissioner of Internal Revenue also claimed said balance of $110,966.08, to apply upon the aforesaid tax liabilities of Graham Ship Repair Co. (R. 71).

The Comptroller General of the United States ruled that said tax claims of the United States, against Graham Ship Repair Co., could be set-off against the amount of $110,966.08, due and owing under said Navy contract NOBs-10230, and administratively effected said set-off (R. 71).

In December, 1946, the Commissioner of Internal Revenue duly assessed against Graham Ship Repair Co. the amounts due from it as to withheld but unpaid tax monies, and duly filed and recorded liens against Graham Ship Repair Co. for such tax monies (R. 71).

SPECIFICATION OF ERROR TO BE URGED

The error is that the right of the petitioner to its security for money loaned, in assigned contract proceeds, as against subsequently arising claims of the United States against the contractor for criminal embezzlement of withheld tax monies, is completely clear, and that the denial of such security by the court below is patently erroneous.

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ARGUMENT

POINT I

The History of the Assignment of Claims Act of 1940 Shows Clear Legislative Intent to Protect Financing Assignee Banks, in the Position of Central Bank, from Liabilities to the United States Which Arise Out of the Subsequent Independent Acts of the Contractor Committed Apart from the Performance of the Contract.

Prior to the passage of the Assignment of Claims Act of 1940, two Federal statutes prohibited the assignment of contracts with the United States, or interests therein (41 U. S. Code, Section 15 and 31 U. S. Code, Section 203; set out infra, Appendix II, page 34).

Said two statutes were amended by the Assignment of Claims Act of 1940 (54 Stat. 1029; set out infra, Appendix II, pages 34-36) Said amendment permitted assignment of such contracts to a bank or financing institution, and further provided as follows:

> "Any contract entered into by the War Department or the Navy Department may provide that payments to any assignee of any claim arising under such contract shall not be subject to reduction or set-off, and if it is so provided in such contract, such payments shall not be subject to reduction or set-off for any indebtedness of the assignor to the United States arising independently of such contract."

Speaking of the no set-off provision above quoted, while it was being debated by the United States Senate, Senator Barkley explained such amendment, as follows (Congressional Record, 76th Congress, Page 12803):

> "Mr. President, the amendment merely provides that when a contractor, in order to obtain money so that he may perform his contract with the Government under the defense program, assigns his contract

to a bank or trust company in order to get money with which to proceed with the work, it shall not be permissible to offset against the claim or contract later an indebtedness which the contractor may owe the Government on account of some other contract or *some other situation.*" (Emphasis added.)

Hearings were held on the Assignment of Claims Act of 1940, before the Senate Committee on Banking and Currency. In the hearing held September 14, 1940, 76th Congress, 3rd Session, Senator Barkley spoke in part as follows (Report of Hearings, page 2):

> "The object of this proposed legislation is to remove the restrictions on these two Sections referred to regarding the assignment of contracts with the Government. The main purpose is to permit contractors who may not have enough working capital—and this particularly affects small contractors—to go ahead with Government contracts; so that if they have to go to the bank and borrow money, they can assign the contract as security and then can get the money and go ahead with the work; then when the work is completed and the Government is ready to pay the contractor, naturally the bank has a *first* claim on it." (Emphasis added.)

POINT II

In Passing the Assignment of Claims Act of 1940 in Order to Get Private Financing for Contractors on War Contracts, the United States Acted in its Business Capacity, To Effect Commercial Transactions; the Rules of Law that Govern Individuals in Such Commercial Transactions Should Be Applied; Such Rules of Law Show that the Set-off Asserted by the United States Should Not Be Allowed.

When the United States passed the Assignment of Claims Act of 1940, in order to get private financing for contractors working on war contracts, the United States

acted in its business capacity, to effect commercial transactions; this means that the United States should be held bound by the same rules of law that govern individuals in such transactions.

In *United States* v. *Seaboard Air Line Ry. Co.*, 22 Fed. 2d 113 (1927), the Circuit Court of Appeals for the Fourth Circuit, in holding that the United States was fully subject to the general rules of commercial law, as to a Bill of Lading to which it was a party, spoke in part as follows (Page 115):

> "And the rule is well settled that, when the 'government * * * comes down from its position of sovereignity, and enters the domain of commerce, it submits itself to the same laws that govern individuals there.' Cooke vs. U. S., 91 U. S. 389, 398, 23 L. Ed. 237; Standard Oil Co. v. U. S., 267 U. S. 76, 45 S. Ct. 211, 69 L. Ed. 519; Chesapeake & Delaware Canal Co. v. U. S., 250 U. S. 123, 126, 39 S. Ct. 407, 63 L. Ed. 889; U. S. v. Bank of Metropolis, 15 Pet. 377, 392, 393, 10 L. Ed. 774; U. S. v. Barker, 12 Wheat. 559, 6 L. Ed. 728; England Nat. Bank v. U. S. (C. C. A. 8th) 282 F. 121."

Accord: United States v. *National Exchange Bank*, 270 U. S. 527, 46 S. Ct. 388 (1926, where Mr. Justice Holmes spoke in part as follows (Page 389):

> "The United States does business on business terms. Cooke v. United States, 91 U. S. 389, 23 L. Ed. 237."

A note in the Yale Law Journal, Volume 60, Pages 548-553, issue of March, 1951, written with specific reference to this case, after pointing out the undesirable consequences of the decision of the Comptroller General which is here in question, indicated the law which should be deemed to be applicable, as follows (pages 551-552):

> "The 'no reduction' clause can be interpreted so as to avoid these results. At common law, the obligor on an assigned contract can set off against the as-

signee's claim obligations of the assignor arising subsequent to notice of the assignment only if they are part of the same transaction. The statutory clause merely extends this rule to prior claims. As to subsequent claims such as those involved in the *Graham* case, the clause should be interpreted to treat the Government exactly as if it were a private party. Reductions should be restricted to those claims which a private obligor could normally assert against an assignee; failure of consideration, breach of warranty, unsatisfactory work, and the like. Claims such as taxes, which accrue to the Government because it is the Government rather than because it is a contracting party, should be excluded under this test as 'independent of the contract.'"

The set-off which the United States asserts should not be allowed because the claim it asserts as to Graham Ship Repair Co. does not arise under the contract at all, and it accrued long after the plaintiff had taken its assignment of contract proceeds and had advanced the money, out of independent criminal acts of the partners of Graham Ship Repair Co. See: *Northwestern Nat. Bank vs. Commonwealth*, 345 Pa. 192, 27 A. 2d 20, Supreme Court of Pennsylvania, 1942.

In this connection, it is to be noted that the Navy Department of the United States, after all contract adjustments, found that there was a balance due, *under the contract*, of $110,966.08 (R 70).

POINT III

The General Commercial Law Applicable Shows That the Claim of the United States As to Taxes Against Graham Ship Repair Co. Is Not the Proper Subject of Set-off As to the Claim of Central Bank for Contract Proceeds.

57 Corpus Juris, on *Set-Off and Counterclaim*, Section 95, pages 444-445, states the applicable law as follows:

> "* * *, it is a broad general rule of practically universal application that to warrant a set-off the demands must be mutual and subsisting between the same parties, and furthermore must be due in the same capacity or right, and there must be mutuality as to the quality of the right."

The tax monies withheld by Graham Ship Repair Co. being held in trust for the United States, the claim of the United States is really a claim as the beneficiary of a trust, arising out of the criminal embezzlement of the trust res by the trustee, Graham Ship Repair Co. Such a claim is so different in nature from the simple claim for contract indebtedness of the petitioner that the two claims lack mutuality, in quality, and are not of a nature to be set-off. This is shown by the decision of the United States Supreme Court in *Western Tie and Timber Co. vs. Brown*, 196 U. S. 502 (1905). There, Western Tie and Timber Co., hereinafter called Tie Co., was engaged in cutting lumber, employing a large number of workers. These workers bought groceries in stores owned by one Harrison. Harrison kept track of the supplies he sold to each employee, and gave a list of such indebtedness to the Tie Co. The Tie Co., in paying its employees, withheld the amount of money which the employees owed to Harrison, and remitted such withheld funds to Harrison. Harrison became bankrupt, owing the Tie Co. over $20,000.00. The Tie Co. had in its hands monies withheld from wages of its employees, in the amount of $2210.75, held out for Harrison. The Tie Co. attempted to set off the withheld monies in its hands, against the indebtedness of Harrison to it, and made claim for the difference, after such set off, against Harrison, in his bankruptcy proceedings. The Supreme Court of the United States held that this could not be done, speaking in part as follows (pages 509-510):

> "This leaves only for consideration the question whether the tie company was entitled to prove its

claim, as it sought to do, for the balance owing, after crediting as a set-off the 'deductions from pay rolls,' to which we have referred. Now, as we have seen, from the facts found, it must be that the agreement between Harrison and the tie company obligated the latter, when it made the deductions from pay rolls, to remit to Harrison the amount of such deductions irrespective of the account between itself and Harrison. It follows that as to such deductions the tie company stood towards Harrison in the relation of a trustee, and, therefore, the case was not one of mutual credits and debts within the meaning of the set-off clause of the bankrupt law. Libby v. Hopkins, 104 U. S. 303."

Section 68 of the Bankruptcy Act of 1898, 11 U.S.C.A. Sec. 108, 30 Stat. 565, under which the above case was decided, provided in part:

"In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other and the balance only shall be allowed or paid."

The claim of the United States is solely against Graham Ship Repair Co., whereas the claim of Central Bank is solely against the United States; this diversity, as to the parties to the two claims, shows that these claims are not mutual claims, and are not the proper subject of set-off.

The applicable law as to this is well expressed by the Court of Errors and Appeals of New Jersey in *O'Dowd* vs. *United States Fidelity and Guarantee Co.*, 117 N. J. Law 444, 189 Atl. 97 (1937), as follows (page 101):

"The whole theory of the right of set-off 'rests in spirit and reason upon the avoidance of circuity of action by compelling the adjustment in one suit of all such mutual demands as are counterclaims.' Naylor v. Smith, 63 N. J. Law, 596, 598, 44 A. 649, 650. And the simple test of the mutuality of the demand

is whether the defendant could recover against the plaintiff in an independent action."

The United States has no cause of action whatever against Central Bank for or on account of the embezzlement of withheld tax monies by Graham Ship Repair Co. Under the law as to mutuality, it appears clear that there is no mutuality between the claim of petitioner against the United States, and the claim of the United States against Graham Ship Repair Co., as to parties; hence, the asserted set-off should not be allowed.

POINT IV

The Facts Show that the Claim of the United States Arises Out of the Subsequent Independent Criminal Acts of Embezzlement Committed by Graham Ship Repair Company.

The petitioner took an assignment of the Navy contract between Graham Ship Repair Co. and the United States, on January 31, 1945, and loaned Graham Ship Repair Co. the monies that enabled it to carry out the ship repair contract.

Such Navy contract (R. 10-56) is completely silent as to any obligations on the part of Graham Ship Repair Co. to withhold taxes from its employees, and pay the same over to the United States.

Sections 1401 and 1622 of the Internal Revenue Code did impose such obligations on Graham Ship Repair Co., and Graham Ship Repair Co. did in fact make such withholdings.

In this situation, the Federal statute delineating the right and duty of Graham Ship Repair Co. was Section 3661 of the Internal Revenue Code, which read as follows:

> "'Whenever any person is required to collect or withhold any internal-revenue tax from any other person and to pay such tax over to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States."

The petitioner submits that the obligation of Graham Ship Repair Co. was not a contract indebtedness, but that Graham Ship Repair Co., as to tax monies it withheld, acted as a trustee for the United States, and held such monies, as trustee, under Section 3661 of the Internal Revenue Code, above set forth. Apart from such trust fund so held, Graham Ship Repair Co. was not indebted to the United States, as to such tax monies. General indebtedness of Graham Ship Repair Co. to the United States, as to such monies, only arose when Graham Ship Repair Co. criminally embezzled the trust res. Such criminal embezzlement was something that had no relation to the contract, and could not possibly have been foreseen or guarded against.

It is true that where an employer does not withhold at all, he becomes generally indebted for the amounts he should have withheld, under Section 1623 of the Internal Revenue Code. This is not the situation in the case at bar, as here the employer did in fact withhold. Having done this, the trust provision of Section 3661 of the Internal Revenue Code immediately was applicable. At this point, Graham Ship Repair Co. was not "indebted" to the United States, but simply was a trustee, owing the duty to turn over the trust res to the United States. This is shown by the consideration that, with such trust fund intact, the United States would have no cause of action at all for a general indebtedness; rather, its sole remedy would be in equity, to compel the trustee to turn over to it the trust res. Subsequently, when Graham Ship Repair Co. embezzled the trust res, it then became generally liable to the United States for the amount of the

embezzlement. These considerations show that the claim of the United States only arises from the subsequent independent criminal act of embezzlement by Graham Ship Repair Co.

The Court of Claims completely lost sight of the nature of the obligation of Graham Ship Repair Co., which was for criminal embezzlement of trust funds, and this contributed to the erroneous judgment of that Court.

POINT V

The Valid Assignment to Central Bank of the Contract Proceeds Vested Legal Title to Such Proceeds in Central Bank, Protecting Central Bank Against Subsequently Arising Claims of the United States for and on Account of Embezzlements of Tax Monies by the Assignor.

The petitioner is an innocent third party assignee, for value, of the contract proceeds. Such assignment vested a legal security title to the contract proceeds in the petitioner.

In *Royal Indemnity Co.* v. *United States*, 117 Court of Claims 736, 93 Fed. Supp. 891, United States Court of Claims, November 7, 1950, the court considered the effect of the assignment, by a contractor with the United States, to a bank, under and pursuant to the Assignment of Claims Act of 1940. The opinion of the majority of the court, speaking, in part, as to this, is as follows (Page 894):

> "The contractor's assignment on May 7, 1945, of all his claims under the contract to the bank as security for credit to be advanced and used for the financing of the contract work complied in every respect with the Assignment of Claims Act of 1940, supra. The bank thus took good legal title to the contract proceeds."

In *Coconut Grove Exchange Bank* v. *New Amsterdam Cas. Co.*, 149 Fed. 2d 73, Circuit Court of Appeals, Fifth Circuit, 1945, the court construed the amendment made by the Assignment of Claims Act of 1940, speaking in part as follows (page 77):

> "The amendment made valid that which had heretofore been void and if it were intended not to affect any rights between the parties relating to the validity of such contracts, why did the Act contain the provision that '*Notwithstanding any law to the contrary* governing the validity of assignments any assignment pursuant to this paragraph and the following paragraph shall constitute a valid assignment *for all purposes*'? (Emphasis added.) If an assignment is valid as to the Government but invalid against the Surety and others, could it be said to be 'valid for all purposes'? If the amendment was only for the protection of the Government, why does it provide that *the Government could not reduce the assigned claim or set it off by any claim that it has against such an assignor?* In addition to protecting the Government, which was the prime purpose of the section before its amendment, as construed in *Martin v. National Surety Co.*, 300 U. S. 588, 57 S. Ct. 531, 81 L. Ed. 822, the amendment of 1940 had the incidental effect of protecting that assignee who filed his assignment and gave notice under the provisions of the statute." (Emphasis added)

The United States has completely disregarded this valid security title of plaintiff, and has illegally attempted to set-off its claim against Graham Ship Repair Co., against the contract proceeds, which are a fund belonging to the plaintiff. The decided cases show that this attempt is completely outside of the law.

In *National Refining Co.* v. *United States*, 160 Fed. 2d 951, Circuit Court of Appeals, Eighth Circuit, 1947, the United States condemned a piece of property, and paid the total consideration into the registry of a Federal district court. Part of the total fund, to-wit, $1,519.75, rep-

resented a commission earned by one R. Newton McDowell. National Refining Co. claimed said commission fund, on the basis of an equitable assignment made to it by McDowell, and pointed to a final judgment of the highest court of Missouri, establishing such assignment. The United States claimed said commission fund, the basis for such claim being stated by the court as follows (pages 953-954):

> "The Government's claim to the fund is based upon a lien for unpaid federal taxes assessed against McDowell for the years 1935 to 1945. The lien was perfected in July, 1945, 'as against any mortgagee, pledgee, purchaser, or judgment creditor' (26 U.S.C.A. Int. Rev. Code, § 3672) by the recording of notices of tax lien. The Government also asserts the right to set off the fund against McDowell's unpaid taxes.
>
> • • • •
>
> The Government argues: * * * (2) that the Government is entitled to set off the fund in the possession of the District Court against McDowell's unpaid taxes; and (3) that the provision of 26 U.S.C.A. Int. Rev. Code, § 3672 that a lien for taxes shall be invalid 'as against any mortgagee, pledgee, purchaser, or judgment creditor,' until notice is recorded, does not apply to appellant, because it was not a 'purchaser'."

The Eighth Circuit Court of Appeals held that National Refining Co. was entitled to the commission fund, speaking in part as follows (page 955):

> "No citation of authority is required to demonstrate that one may not set off against a debt a nonexistent obligation or *a fund belonging to someone other than the debtor.*" (Emphasis added)

Accord: *In re Astoria Boulevard*, 171 Misc. 1018, 13 N. Y. Supp. 2d 433, New York Supreme Court, Queens County, 1939.

United States Fidelity & Guaranty Co. vs. Triborough Bridge Authority, 297 N. Y. 31, 74 N. E. 2d 226, New York Court of Appeals, 1947.

Karno-Smith Co. vs. Maloney, 112 Fed. 2d 690, Circuit Court of Appeals, Third Circuit, 1940.
United States vs. Rosebush, 45 Fed. Supp. 664, District Court, Wisconsin, 1942.

In this regard, it must be remembered that the United States, as to its claim against Graham Ship Repair Co., is solely in the position of asserting an unsecured creditor's claim against the partners of Graham Ship Repair Co. *In re Frank*. 25 Fed. Supp. 1005, District Court, Southern District of New York, 1939.

POINT VI

As Central Bank Is a Bona-Fide Purchaser for Value of the Contract Proceeds, the Subsequent Independent Criminal Fraud of the Contractor Should Not Work Forfeiture of the Banks Security Title.

The vital defect in the attempted set-off asserted by the United States is that the claim it asserts does not arise under the contract at all, but arises solely out of subsequent independent criminal fraud practiced by Graham Ship Repair Co. upon the United States. The petitioner had nothing whatever to do with the subsequent fraudulent acts of Graham Ship Repair Co., and such acts should not be permitted to defeat the antecedent security rights of a third party bona fide purchaser.

Arlington Trust Co. vs. United States, 100 Fed. Supp. 817, Court of Claims, November 6, 1951, is applicable. There, Arlington Trust Co. loaned money on war contracts to Leyde and Leyde, taking an assignment of the contract proceeds as security. Subsequently, Leyde and Leyde put in a fraudulent claim against the United States, as to the contracts, thereby forfeiting their claim. The Court held, however, that the plaintiff Trust Company was in the position of an innocent purchaser for value,

and that the subsequent fraud of the contractor on the United States should not be allowed to prejudice such innocent assignee. The Court spoke in part as follows (pages 818-819):

> "But the plaintiff here is a Trust Company, which, we suppose, loaned money to Leyde and Leyde, to finance the performance of the contracts in suit. It had no part in the fraud.
>
> * * * * *
>
> "The plaintiff is, presumably a purchaser in the sense that it loaned money to Leyde and Leyde when it took its assignments of the contracts. When we look at the purpose of the 1940 amendment to the Assignment of Claims Act, 31 U. S. Code 203, which was to enable contractors with the Government to obtain from private sources funds to finance their performance, we think it could not have been intended by Congress that the bank which loaned the money should take the risk that its collateral might, in an instant, be rendered worthless by the act of the contractor in committing fraud in the presentation of proof of his claim under the contract."

In *Central Nat. Bank of Richmond, Virginia* v. *United States*, 91 Fed. Supp. 738, United States Court of Claims, 1950, one Kent contracted with the United States, in 1945. Kent borrowed money, to carry out the contract, from Central National Bank of Richmond, and, pursuant to the Assignment of Claims Act of 1940, assigned all payments due or to become due under the contract to the said bank. The contract provided for such assignment. The bank gave proper notification, pursuant to the Assignment of Claims Act of 1940. Despite such notification, the United States erroneously made payment, direct to Kent, in the amount of $11,193.55. Kent held the Government check for a time, then cashed it and used the proceeds for his own purposes. The United States refused to pay said sum of $11,193.55 to Central National Bank of Richmond. The bank brought suit to recover same.

The court held in favor of the plaintiff, speaking in part as follows (page 740):

> "Prior to the enactment of the Assignment of Claims Act of 1940, 31 U. S. C. A. § 203, assignments such as the one with which we are here dealing were expressly declared void by law. The 1940 act was intended to facilitate emergency financing of the vast war program and designed to permit established lending institutions to provide immediate funds for contracts incident to the war effort. This very purpose of the act is aptly described in its title:
>
> 'An Act
>
> 'To assist in the national-defense program by amending sections 3477 and 3737 of the Revised Statutes to permit the assignment of claims under public contracts.'
>
> * * * * *
>
> "That Congress intended to validate the very kind of assignment here involved 'notwithstanding any law to the contrary governing the validity of assignments' is perfectly obvious.
>
> "Furthermore, the effect of such enactment was to place the Government in the same position as that of any ordinary debtor. *United States* v. *Standard Rice Co.*, 323 U. S. 106, 65 S. Ct. 145, 89 L. Ed. 104. When a question regarding assignments as they affect the Government arises, the general law of assignments must govern.
>
> "Plaintiff's assignment was made pursuant to the Act of 1940 and notice thereof was given in the manner and to the officials as required. Having so complied with the act, plaintiff is entitled to that degree of protection ordinarily given to an innocent assignee who acts in good faith."

It is to be noted that, in the above case, Kent embezzled and/or converted part of the contract payments, to his own use, thereby coming under an immediate liability to the United States to repay such sums so embezzled by him. Hence, said case is similar to the case at bar, where the Grahams embezzled monies which they should

have turned over to the United States. In the case at bar, said embezzlement was remote, so far as the contract was concerned. In the *Central National Bank of Richmond* case, the embezzlement was of the contract proceeds themselves. Accordingly, the *Central National Bank of Richmond* case is an à fortiori precedent, demonstrating the right of the petitioner to recover in the case at bar.

POINT VII

The Claim of the United States Arose Under the Internal Revenue Code, Out of Criminal Acts of Graham Ship Repair Company Occurring After the Assignment of Contract Proceeds To Central Bank; Such Claim Arose Independently of the Contract.

The claim which the United States asserts arises out of the application of the Internal Revenue Code to subsequent acts of Graham Ship Repair Co. Graham Ship Repair Co. only became liable on such claim when it criminally embezzled and converted the trust res, to-wit, the tax monies which it had withheld. It seems clear that such subsequent independent criminal acts of the contractor, Graham Ship Repair Company, should not prejudice a previous bona fide assignee, for value, of the contract proceeds. Central Bank, the assignee, had no control over Graham Ship Repair Company, and it was the United States which had extended trust to Graham Ship Repair Company, by making such company its own statutory agent to handle withheld Federal taxes. The normal assumption in the business world is that persons will act in accordance with law, and will commit no crimes. The commission of criminal acts by the contractor, long after the valid assignment to Central Bank, would clearly seem to be a matter arising independently of the contract. The relation of such embezzlements to the contract is indeed remote, and the petitioner submits that the United States

cannot reasonably compel a lending bank to guarantee the subsequent honesty and freedom from embezzlements of the contractor, under penalty of losing its security. Surely, the later intervention of felonious embezzlement by the contractor was a matter that the petitioner could not guard against, and was a matter bearing no relation to the contract, upon objective appraisal.

In any event, the liabilities which the United States asserts can only be shown by application of the provisions of the Federal Internal Revenue Code to facts which all occurred after Graham Ship Repair Company had assigned the contract proceeds, for value, to Central Bank.

The contract itself contains nothing which could, by any stretch of the imagination, give rise to such a liability.

The liability asserted is statutory, exists without reference to the contract, and could not be affected in any way by the provisions of the contract.

This is illustrated by the case of *United States* v. *Swedlow Engineering Co., Inc. & Fireman's Fund Indemnity Co.*, D. C., Southern District of California, October 24, 1951, reported in 1951 Prentice-Hall Federal Tax Service, Paragraph 72, 603. Here, the engineering company, performing a contract with the United States, had the indemnity company as surety on a bond, conditioned upon payment of labor and materials. The engineering company, being out of funds, asked the indemnity company to furnish payroll funds. This the indemnity company did, by putting up money with a bank, on pay day, with instructions to use the money to cover the payroll checks of the engineering company. The engineering company failed to withhold taxes, including Federal income taxes, Federal Insurance Contributions Act Taxes, and Federal Unemployment Taxes. Subsequently, the engineering company became bankrupt. The United States brought

suit against the indemnity company, seeking to recover the amount of such taxes that were not withheld.

The court decided in favor of the United States, speaking in part as follows:

> "Here the 'trust fund' is created by statute (26 U.S.C.A. Section 3661). The bonding company paid the wages as they became due. Without the periodical drafts to cover them, they could not have been paid. In the circumstances, the bonding company was 'the employer'. And the obligation to pay does not arise under the bond. It arises under the statutes of the United States referred to. And the bond is merely the source under which the bonding company was substituted as the employer for the contractor who was in financial difficulties."
>
> * * * * *
>
> "The bonding company, by taking control of the payment of the wages, through the method described, became obligated under Sec. 1621(d)(1) of the Int. Rev. Code, to pay all the wages, including the portions to be withheld. Their failure to do so establishes their liability, not under the bond, but under the Internal Revenue Statute."

Speaking of the control of the payment of the wages, which the bonding company acquired, the court further said:

> "With it passed the duty to withhold, imposed by the Internal Revenue statutes. The obligation which they failed to perform was that prescribed by these statutes. They are the basis of their liability and of the Government's claim. The limitations which apply are only those contained in the Internal Revenue Code."

When the contract proceeds were assigned, no one could predict or know whether or not Graham Ship Repair Company would or would not ever become obligated, under the Federal Internal Revenue Code, for any sums withheld as Federal taxes. Graham Ship Repair Com-

pany could have sub-contracted out the work, and never have had any liability at all; or, Graham Ship Repair Company, due to exemptions of its employees under the Internal Revenue Code, might have no liability whatever.

The question as to whether any liability of Graham Ship Repair Company for withholding of Federal taxes would ever arise depended completely upon (1) the provisions of the Federal Internal Revenue Code, in force for periods of time *after* the assignment had been made, and (2) upon future states of facts, not humanly predictable, and the impact of the provisions of the Internal Revenue Code upon those facts.

The contract did not and could not validly deal, in any way, with the obligations of Graham Ship Repair Company as to withholding of Federal taxes, because such obligations were determinitively fixed by the Internal Revenue Code, and such obligations were completely independent of the contract and all of its provisions.

The respondent points to the coincidental fact that, by facts occurring subsequent to the assignment, Graham Ship Repair Company became liable for Federal withholding taxes with reference to wages paid to employees working on contract work. This liability arises independently. The tenuous and factually coincidental connection upon which the defendant relies clearly arises independently, for it is to be remembered that not only does it arise as a statutory liability, but it also depends upon the subsequent occurrence of criminal acts of embezzlement by Graham Ship Repair Company.

The assignment of contract proceeds to Central Bank was made before any wages had been paid, and before any withholding of taxes had occurred. If, prior to the payment of wages by Graham Ship Repair Company, the withholding of taxes provisions of the Internal Revenue Code had been repealed, this would not have made one

iota of difference as to the contract or its performance; nothing could more clearly demonstrate that the liability the United States asserts is purely statutory, and completely untouched by the contract or the contract provisions.

POINT VIII

Concepts of Fairness and Honesty in Business Dealings Show That the Innocent Financing Bank Should Be Protected in its Security Against the Subsequently Arising Claims of the United States Against the Contractor for Criminal Embezzlement of Withheld Tax Monies.

The United States passed the Assignment of Claims Act of 1940 to induce banks to lend, safely and freely, upon the assignment of war contracts. This was done to help the war effort. The petitioner bank loaned money, in reliance upon this Act, on the war contract here involved. In so doing, the bank relied upon the clear wording and meaning of the Statute, and made the reasonable interpretation that claims relating to taxes, against the contractor, accruing subsequent to the assignment, did not dilute or defeat the banks assignment and security rights.

This was the view of the Comptroller General of the United States. In 20 Decisions of the Comptroller General 458 (1941), the Federal Farm Security Administration proposed to make loans to persons who had contracts with the United States War and Navy Departments, for sale or lease of land to such Departments. The Farm Security Administration asked the United States Comptroller General for his opinion, as to whether or not the United States could set-off such loans, in cases where the borrowers had previously assigned the contract proceeds under the Assignment of Claims Act of 1940. The Comp-

troller General ruled in the negative, speaking in part as follows:

> "In the event of a valid assignment pursuant to the Assignment of Claims Act of 1940, Public, No. 811, approved October 9, 1940, made prior to the date of the making of a loan by the Farm Security Administration it would appear that the right of set-off would not be available to the Farm Security Administration as against the assignee of monies due under the contract assigned. While an assignee acquires no greater rights through an assignment than his assignor had at the time of the assignment, and takes the assignment subject to any existing right of set-off, his rights under the assignment are not affected by independent claims subsequently accruing in favor of the Government against his assignor. That is to say, a debtor cannot set off rights acquired under other transactions subsequent to the date of receipt of notice of a valid assignment."

This construction and interpretation of the assignment of Claims Act of 1940 was made by the Comptroller General of the United States in 1941, before Central Bank loaned money to Graham Ship Repair Company, and took assignment of the contract. It clearly indicated the general understanding, as to protection of an assignee who advanced money under the Assignment of Claims Act of 1940, against subsequently accruing claims of the Government against the contractor.

The United States obtained the financing which it desired.

Having achieved this, the United States subsequently evolved a technical, strained, and unsound theory for the construction of the Assignment of Claims Act of 1940, in an effort to defeat the security rights of the petitioner bank in the assigned contract proceeds.

The position that the United States adopts, in this situation, is strikingly inequitable.

The adoption of such a position, by a private business concern, in an equivalent situation, would very quickly achieve for such concern a reputation for sharp practice and unconscionable dealing.

The adoption of such a position by the United States is unworthy of our great country. The vitally important factor as to the adoption of such a position is that it shakes the faith of private business concerns in the business integrity of the United States.

The strained and unsound theory for the construction of the Assignment of Claims Act advanced by the United States in this suit should be rejected, or the adoption of it would result in an inequitable defeat of the security rights of an innocent private assignee, Central Bank, which advanced money in reliance upon the clear wording and meaning of the Statute, as hereinbefore shown.

CONCLUSION

For all of the foregoing reasons, the judgment of the Court of Claims should be reversed, and the case remanded for entry of an appropriate judgment protecting the petitioner in its security.

Respectfully submitted,

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APPENDIX I

Discussion of the Precedents Cited by the Court of Claims in its Opinion of July 15, 1952

The Court of Claims cited the following four cases in its opinion of July 15, 1952 (R. 76, 78). The petitioner respectfully submits that these cases are inapplicable and do not support the judgment of the Court of Claims, and in that regard makes the following analysis of them:

In *Modern Industrial Bank vs. United States,* 101 Court of Claims 808, the contractor defaulted in the performance of its contract, and the United States terminated the contract because of the default. The financing bank, assignee of the contract proceeds, sought to recover the full contract price, based on percentage of completion, without regard to the money damage caused to the United States by the contractor's default. The holding of the court was that the damage caused by the contractor's breach of the contract should be deducted from the amounts otherwise payable under the contract. This is a clear case, and completely sound. It does not apply to the case at bar, however, because in the *Modern Industrial Bank* case the damage to the United States arose directly out of breach of the contract itself; in the case at bar, the damage caused to the United States did not arise under the contract at all, but arose out of the subsequent, independent criminal embezzlements of the tax monies, by the contractor, in violation of the Internal Revenue Code and of Federal criminal statutes.

In *United States vs. Munsey Trust Co.,* 322 U. S. 234, 67 Supreme Court 1599 (1947), the plaintiff claimed contract proceeds in the right of a surety company which had taken an assignment of such proceeds as surety. The surety company had been forced to pay sundry unpaid claims for labor and material. However, there was no statute authorizing such an assignment of contract pro-

ceeds to a surety, and accordingly the surety had no true security at all, and was simply in the position of a general creditor as to the contract proceeds. This being so, the United States, which also had a general creditors' claim was entitled to use set-off to pay itself. The case at bar is very different. The assignment to Central Bank was specifically authorized by the Assignment of Claims Act of 1940; Central Bank had a valid assignment of the contract proceeds, and was a secured creditor. The claim against Graham Ship Repair Co. (which the United States asserts) is a general creditor's claim. Such claim, arising after the security to Central Bank had become effective, and arising out of the independent criminal acts of the contractor, is not the proper subject of set-off against the secured claim of Central Bank. There is nothing in the holding in the *Munsey Trust Co.* case which supports the position of the respondent, and the petitioner respectfully submits that said case is inappropos.

Seaboard Surety Co. vs. United States, 108 Court of Claims 759, 67 Fed. Supp. 969 (1946) makes a holding essentially similar to the holding in the *Munsey Trust Co.* case. The rationale and language of the Court in the *Seaboard Surety Co.* case strongly support the position of the plaintiff in the case at bar. The essential fact in the *Seaboard Surety Co.* case was that the surety company did not have a valid assignment of contract proceeds, and hence had no security; in the case at bar, Central Bank had a valid assignment, and was in the position of a bona fide secured creditor.

Royal Indemnity Company vs. United States, 117 Court of Claims 736, 93 Fed. Supp. 891 (1950) involving a preexisting equitable lien upon contract proceeds, held by a surety company. The holding of the court was that such preexisting equitable lien took precedence over a subsequent assignment of the contract proceeds to a financing bank, under the Assignment of Claims Act of 1940. It

is to be noted that the financing bank took its assignment with full notice and knowledge of the preexisting equitable lien and rights of the surety company. In addition, the equitable lien of the surety company was a valid security, as between itself and any other private claimant. The *Royal Indemnity Company* case is markedly different from the case at bar. In the case at bar, Central Bank loaned money and took the assignment of contract proceeds at a time when there was no claim whatever by the United States in existence; Central Bank thus became a bona fide secured creditor, and the subsequently arising general creditors claim of the United States, arising out of the independent criminal acts of the contractor, does not constitute the proper subject matter of set-off as against the preexisting security taken in good faith by Central Bank.

APPENDIX II

Revised Statutes:

Sec. 3477. All transfers and assignments made of any claim upon the United States, or of any part or share thereof, or interest therein, whether absolute or conditional, and whatever may be the consideration therefor, and all powers of attorney, orders, or other authorities for receiving payment of any such claim, or of any part or share thereof, shall be absolutely null and void, unless they are freely made and executed in the presence of at least two attesting witnesses, after the allowance of such a claim, the ascertainment of the amount due, and the issuing of a warrant for the payment thereof. Such transfers, assignments, and powers of attorney, must recite the warrant for payment, and must be acknowledged by the person making them, before an officer having authority to take acknowledgments of deeds, and shall be certified by the officer; and it must appear by the certificate that the officer, at the time of the acknowledgment,

read and fully explained the transfer, assignment, or warrant of attorney to the person acknowledging the same.

* * *

Sec. 3737. No contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States are concerned. All rights of action, however, for any breach of such contract by the contracting parties, are reserved to the United States.

Assignment of Claims Act of 1940, c. 779; 54 Stat. 1029:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That sections 3477 and 3737 of the Revised Statutes be amended by adding at the end of each such section the following paragraph:

"The provisions of the preceding paragraph shall not apply in any case in which the moneys due or to become due from the United States or from any agency or department thereof, under a contract providing for payments aggregating $1,000 or more, are assigned to a bank, trust company, or other financing institution, including any Federal lending agency:

Provided,

"1. That in the case of any contract entered into prior to the date of approval of the Assignment of Claims Act of 1940, no claim shall be assigned without the consent of the head of the department or agency concerned;

"2. That in the case of any contract entered into after the date of approval of the Assignment of Claims Act of 1940, no claim shall be assigned if it arises under a contract which forbids such assignment;

"3. That unless otherwise expressly permitted by such contract any such assignment shall cover all amounts pay-

able under such contract and not already paid, shall not be made to more than one party, and shall not be subject to further assignment, except that any such assignment may be made to one party as agent or trustee for two or more parties participating in such financing;

"4. That in the event of any such assignment, the assignee thereof shall file written notice of the assignment together with a true copy of the instrument of assignment with—

"(a) the General Accounting Office,

"(b) the contracting officer or the head of his department or agency,

"(c) the surety or sureties upon the bond or bonds, if any, in connection with such contract, and

"(d) the disbursing officer, if any, designated in such contract to make payment.

Notwithstanding any law to the contrary governing the validity of assignments, any assignment pursuant to the Assignment of Claims Act of 1940 shall constitute a valid assignment for all purposes."

Any contract entered into by the War Department or the Navy Department may provide that payments to an assignee of any claim arising under such contract shall not be subject to reduction or set-off, and if it is so provided in such contract, such payments shall not be subject to reduction or set-off for any indebtedness of the assignor to the United States arising independently of such contract.

(31 U.S.C. 1946 ed., Sec. 203; 41 U.S.C. 1946 ed., Sec. 15.)

INTERNAL REVENUE CODE

Sec. 1401.

(a) REQUIREMENT.—The tax imposed by section 1400 shall be collected by the employer of the taxpayer, by

deducting the amount of the tax from the wages as and when paid.

(b) INDEMNIFICATION OF EMPLOYER.—Every employer required so to deduct the tax shall be liable for the payment of such tax, and shall be indemnified against any claims and demands of any person for the amount of any such payment made by such employer. * * *

Sec. 1622.

(a) REQUIREMENT OF WITHHOLDING.—Every employer making payment of wages shall deduct and withhold upon such wages a tax equal to 18 per centum of the amount by which the wages exceed the number of withholding exemptions claimed multiplied by the amount of one such exemption as shown in subsection (b) (1), except that in the case of wages paid on or after November 1, 1951, and before January 1, 1954, the tax shall be equal to 20 per centum of such excess in lieu of 18 per centum. * * *

SEC. 1623.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this subchapter, and shall not be liable to any person for the amount of any such payment.

SEC. 3661.

Whenever any person is required to collect or withhold any internal-revenue tax from any other person and to pay such tax over to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.